

ADJUSTMENTS TO THE CURRENT SYSTEM

Basic description (what is now occurring in FFEL)

Competition has increased in various aspects of FFEL in recent years. For example:

- Guarantee fee waivers
- Origination fee discounts
- Back-end discounts to borrowers in repayment
 - some contingent on borrower behavior, others non-contingent
 - some contractual--that is, borrowers are entitled to them by terms on the loan papers they sign; others can be withdrawn by lenders
- Some front-end reductions in borrower interest rates
- Most of the current discounts were recently instituted--may not persist if conditions change
- Not available to all borrowers
 - some depend on borrower behavior
 - some depend on the borrower's state of residence or enrollment
 - some depend on the type of school attended

In other areas of FFEL, competition has been a part of the program during much of the 1990s:

- Loan servicing, secondary markets (however, both are becoming more highly concentrated)
- Quality of service (lenders, servicers, and guarantors all compete)
- Competition from Direct Loans may have influenced both price and quality-of-service competition

However, the lender's gross yield from FFEL is an area in which there is no competition. The Congress sets the mark-ups over the reference rate. The Congress makes this determination for significant periods of time (generally 5-7 year periods) without good market information or cost data. The Federal government does not benefit from any technological change or other change that reduces lenders' costs--it pays the same amount to the lender.

Possible variations (proposed modifications)

Possible modifications to the system include:

- Make incremental adjustments to the add-on and monitor changes in loan availability until universal access is threatened.
- Measure the cost of funds used to make the loans, and provide an add-on for administrative expenses and a reasonable profit, to set the rate.
- Establish a commission to set the lender yield
- Measure the value of student loans to the secondary market to set lender yields

Issues to consider:

- Changes in technology have resulted in significant reductions in the cost of servicing loans, including student loans. Further changes are likely in the future with greater use of e-commerce.
- Federal student loan policy has dictated uniform terms and conditions on student loans. This results in the Federal government paying subsidies (in-school interest, special allowance, and/or guarantee payments) on all loans when some loans may be profitable without the payments.
- Data collection and reporting burdens could be extensive under some of these options, and all would require greater disclosure than is the case today. Lenders, servicers, and secondary market procurers of student loans may want some limits on disclosure of proprietary information.
- The trend toward consolidation of operations within the student loan system has been ongoing. However, this trend seems to be accelerating. Modifications to the system (as well as the market mechanisms analyzed below) could be evaluated to determine whether they would slow or expedite the consolidation process.

TREASURY FUNDING

Basic description

- Private lenders continue to originate loans as usual, except that they would have the ability to borrow funds from the U.S. Treasury--either at a fixed margin relative to a Treasury rate, or at a margin that is subject to a bidding process. Lenders could still choose to fund student loans through their traditional methods.
- Direct Loan program would remain as is, with terms for borrowers the same as in FFEL
- Lender (gross) yield in FFEL would be equal to what the borrower pays
- The borrower reference rate could be any rate--but because funding will be Treasury-based, makes sense to keep this rate Treasury-based. Could change from 91-day rate to a longer-term rate if desired.
- Guarantee terms same as in current system.

Possible variations

Treasury could offer funding at a fixed margin above a reference rate.

- Lender could borrow some amount at this rate--volume would have to be limited somehow, and/or lenders would have to immediately return excess loan volume.
- The margin used to set the funding rate could be adjusted each year (although it may well be as difficult to set this as it affects the current lender yield)
- The pricing of Federal funds for lenders would remain a political decision.

On the other hand, lenders could bid for the right to borrow at a Treasury-based rate.

- Education estimates the volume of loans borrowers will demand. Treasury offers to lend, say, 95 percent of this amount. Volume is divided into several (3 to 6) groups by level of student and type of school (with a small set aside for non-competing lenders in each group, who would pay the rate set through the competitive bidding).
- Bids are schedules of off-sets from the student rate and volume desired at that off-set. A schedule is submitted for each of the 3-6 borrower/school groups. Could establish minimum bid and/or cap (such that no single lender can capture an unhealthy share of these loans, as in current Treasury auctions).
- Bidding is resolved with uniform-price distribution of funding--cut-off price is the highest off-set at which the sum of the desired volumes within the group at or above this price just exhausts the Treasury loan volume being allocated there. All lenders receive the allocation they bid at this off-set. If they bid no volume at this off-set, they can change their minds and receive a small allocation from the set aside.

A third variation would have the Federal government play the role of the current secondary market by buying loans from originating lenders.

- This assures that lenders have ready access to capital.

- The loans purchased by the Federal government could be serviced as if they were originated as a direct loan, or the government could choose to purchase servicing from the originating lender.

Issues to consider:

- In general, this option would leave other aspects of the program unchanged. Lenders would have the option of borrowing from Treasury but could ignore this system altogether and participate and compete as they do now. No long-term relationships between schools and lenders, GAs, servicers need be affected. (The borrower rate would have to be adequate to make nonparticipation a realistic option for lenders.)
- Capital would always be available. Small lenders would (at least under the non-auction option, and perhaps to some extent under the auction version) have the opportunity to acquire funds at the same cost as larger lenders. By giving lenders a Treasury-based source of funds, this model could allow the borrower rate to remain Treasury-based and give lenders ability to match-fund--might have been more relevant before the switch to a CP index, but yield is scheduled to return to a Treasury index in 2003.
- Significant involvement by Treasury would be required. Treasury may want to establish standards to qualify lenders that could participate.
- Most of the market mechanisms set the gross yield; this one affects the cost side (it still affects net yield).

VOLUME PROCUREMENT/LOAN ORIGATION RIGHTS AUCTION

Basic description

- Lenders bid for the right to originate loans in the FFEL program--under some models, only lenders who win an allocation would be eligible to make loans; under other models, some volume would be reserved for non-bidding lenders
- Rights could be bought and sold after they are allocated at auction but before loans are originated
- Lenders bid for either specific schools or a total volume--could submit multiple bids that incorporate different prices, and bids could be negative

Possible variations

These auctions include three possible models:

- A "Volume procurement" process--lenders bid on allocations that can be used for originations at any school and the pay the price bid
- An income dependent education assistance (IDEA) model of "volume procurement" with income contingent repayment--lenders bid on allocations that can be used for originations at any school and the pay the next highest price bid; borrower subsidies shifted to the repayment period through (1) income-contingent repayment (ICR, which we treat later), and (2) the elimination of in-school interest payments by the government on the borrower's behalf
- A "rights auction" model--lenders bid on allocations at specific schools
- A "no volume" auction in which lenders bid purely on the interest rate which they are willing to accept. Under this approach, lenders would bid an "add-on" to a T-bill, CP, or LIBOR index. The "losers" in this auction could still make loans at the "winning" rate, which could be second lowest rather than lowest bid.

Under these models, lenders win the rights to originate loans, but they differ as to

- whether lenders bid on specific schools or an allocation that can be used at any school, and
- whether winning lenders each pay what they bid, each pay what the next-ranked bidder bid, or all pay a common price.

Issues to consider:

- Many specific alternatives for implementing an auction could be used. For example, program could allow allocation to be used nationally, or there could be separate allocations by type of school or geographic area; provision could be made for small bidders; etc.
- Some lessons from Federal government experiences with auctions are instructive:
 - EPA auctions reveal the importance of secondary market (which actually allocates more rights than the auctions do) and the failure of the government's ability to predict/set price outside of auction. EPA was also criticized for not going to uniform price method (but pricing method used in the auction may be irrelevant given presence of the secondary market).

- Treasury auctions showed that uniform bidding resulted in less market concentration, small noncompetitive bidders can be included, and collusion can become an issue.
- FCC requires a deposit and established a monetary penalty for withdrawing bids. It uses a multiple-round bidding method to provide information on value of assets--similar to information available from secondary markets in Treasury securities and emission rights. Some evidence that bidders have an incentive to collude, especially if a group is large relative to the market.
- HEAL auctions revealed significant strengths and weakness in student loan auctions. The auction process resulted in significant reductions in borrower interest rates, which were also set via the process. There were 4 or 5 large HEAL lenders in the last few years until the very last year, when there was just one. Moreover, lenders entered and reentered--there was not a gradual reduction of lenders that led inexorably to one lender who had been there throughout. HEAL volume was limited by appropriation, and lenders could exhaust their allocation before making all loans they desired at a school. In these cases, either the lender would need to apply for a new allocation or the school might need to find another lender--disrupting the process in either case.
- If similar schools are bundled together (a bundle of 4-year private schools, another bundle of less-than-2-year low-tuition proprietary schools, etc.) for auction, then bids could vary a great deal. Lenders' net yields could be equalized across schools, and the auction results could reveal the subsidy that is currently hidden in FFEL, i.e. that students in less-profitable schools (low loan balance, high default) are subsidized more heavily than those in more-profitable schools (high loan balance, low default).
- Auction timing and frequency would affect loan serialization--that is, the issue of whether all of a borrower's series of loans ends up with the same loanholder or servicer.
- Schools may want to continue to play a gatekeeper role in the relationship between borrowers and lenders. This desire may work in some cases against any truly market-based approach.

LOAN PAPER SALE/AUCTION

Basic description

This category includes three variants on a loan auction concept. These models differ somewhat in terms of how origination takes place and how the subsequent sale is conducted. However, in each model, private lenders obtain loans sometime after they are originated. Bidding would determine not the rights to originate the loans but rather the sale price of loans already originated.

Possible variations

Loans could be originated in several ways:

- The Federal government could originate loans and then sell to bidding lenders, either
 - right after origination, or
 - after borrowers begin repayment (to keep each borrower's loans together).
- Some other entity could originate the loans, while government divests the asset through the sale of loans via auction

Several other aspects of the auction could vary:

- Auctions could be held annually or more or less frequently
- Lenders could bid for the right to purchase loans from government for an incoming cohort of students/first time borrowers
- Auctions could be conducted for loans at schools as bundled by geographic region or by type of institution
- Loans could be sold with or without a Federal guarantee (or with a guarantee of some level other than 98 percent)
- One proposal envisions lenders financing the purchase of loans--paying for them as borrowers make their repayments, at some interest rate that would accrue to the Treasury--rather than paying a lump sum up front to purchase the loans

Issues to consider:

- The Federal government could retain loans until a borrower leaves school and then ensure that all loans for a particular borrower were part of the same bundle. While this would minimize serialization problems, it would mean smaller auctions and would also require a servicing arrangement, such as that that exists today for Direct Loans, for the government-held loans. The government, however, would likely receive a higher price for loans auctioned/sold during grace or repayment because of larger balances per borrower.
- Consideration of loan consolidation might be necessary if the borrower returns to school after his or her loans are sold. This could be through a Federal program, with the new consolidation loan

being re-auctioned. Alternatively, the borrower could consolidate with a particular lender and then deal just with that lender, as today.

- The sale of Direct Loans has been raised as a possible pilot for a loans auction model. There may be complicating factors with this approach. For example, budget considerations may make this approach quite costly. If the program were established, it could presumably incorporate both FFEL and DL, or a portion of the loan portfolio could remain as DL without being sold.
- The Federal government would undoubtedly continue to be concerned about the quality of service that a lender would provide to a borrower. The issue of how quality service can be assured is particularly of concern when the loans are sold with a guarantee. However, even without the guarantee, the Federal government will certainly be interested that all borrowers receive fair and equal treatment.

STUDENT SHOP

Basic description

This category covers an array of proposals that would have students shopping for loans in the market place as they do today in the private loan market. Two specific variations of the models were offered:

- the Federal Housing Administration (FHA) insurance model, and
- a model based on the private loan market, but incorporating a guarantee.

(This latter model has 2 variations. One of these variations would explicitly include a process for incorporating ICR; we defer discussion of ICR to a later section.) In each of these alternatives, the borrower's interest rate and fees would no longer be set by legislation. Instead, they would emerge from negotiations between lenders and borrowers--or more likely lenders and schools. Lenders may be willing to assume enough common characteristics across borrowers at a school that they find it more efficient to give the same rate to all a school's borrowers than to try to negotiate with each borrower.

Possible variations

- The models based on private loans are similar in determining both borrower's rate and the lender's yield.
- The model based on FHA limits the variation between the highest and lowest rates lenders offer on a given day to be no more than two percentage points within markets defined by geographic region and "risk characteristics," among other factors.
- In addition, the FHA model could incorporate a change in the way guarantee authority is granted. FHA allows some participating lenders to essentially self-certify their mortgages for insurance. It is not clear whether the proposal envisioned a change to a similar feature for the FFEL program.
- None of the proposals discuss subsidies to offset the effects on borrowers of possibly widely varying rates. One of the private loan variations uses ICR to explicitly shift subsidies to the back-end; all borrowers would be able to take advantage of these as needed.

Issues to consider

- Federal student loan policy has dictated uniform terms and conditions on student loans. This policy would be abandoned under this approach. This would be a major public policy change and raise equity and access concerns. There are several possible implications stemming from these concerns:
 - An absolute maximum rate would seem to be impractical. If no borrower had to pay over a cap of T-bill + 3.5 percent, say, then school/borrower would have no incentive to negotiate if the rate would end up above that level anyway.
 - Alternatively, a lender of last resort (LOLR) could be established for all schools that could not get a satisfactory rate. The LOLR could be a private lender (would need to decide how that

lender is compensated) or Direct Loans (DL) (representing a major change in risk profile of DL portfolio).

- Finally, a borrower's subsidy could be provided by having the government pay some amount of their interest--1 or 2 percentage points--off the rate they negotiate. The borrower or schools would still have an incentive to negotiate as good a rate as possible, because the better the rate, the less they or their students would pay even after the subsidy. The amount of the subsidy could differ for different schools or categories of schools, to try to bring all borrowers down to something like a common rate.
- The FHA limitations on the range of rates might not have much practical effect. Offered rates can vary by more than the 2-percentage-point range for borrowers with different "risk characteristics," so the effect would depend on how widely or narrowly these categories were drawn.

INCOME-CONTINGENT REPAYMENT

Issues and proposals

This is one of the 13 criteria to be discussed for each model, but many of the issues and analysis are substantially the same across the different models. The two proposals that describe income-contingent repayment (ICR) plans work similarly, and this form of ICR could possibly be adapted to most or all of the models. Questions that would occur--about the possibility of negative amortization, ultimate forgiveness of outstanding principal after some number of years, IRS involvement--would be similar for each of the models. Thus, rather than repeat the discussion with each of the preceding models, we analyze the topic separately.

The proposals to date that incorporate ICR envision these loans being held by the government:

- Loans are first held by private lenders
- The government buys loans from private lenders if borrower chooses ICR

A more recent contribution has incorporated ICR for privately held loans:

1. Private lenders could offer ICR based upon the borrower's self-certifying his or her income. Borrowers would be advised that self-reported data would be subsequently compared with data reported to the IRS. They would also be advised that failure to correctly report might jeopardize their continuing ability to participate in ICR.
2. On an annual basis, lenders would share the self-certified income information from ICR participants with the Department of Education.
3. The Department of Education would--through its arrangements with the Department of Treasury--compare the self-reported data to the actual data. If the self-reported data were within defined tolerances, the borrower would continue to be eligible for ICR. If the self-reported data were lower than the prescribed tolerances, lenders would be advised that the borrower's self-reported income was outside an acceptable tolerance. The lender would advise the borrower that they had lost their eligibility for ICR and immediately convert them to another repayment option.
4. The government would pay balances remaining at the conclusion of the 25-year ICR timeframe.

Features of loan programs in other countries

Most countries that use ICR have only government (direct) loans. The United Kingdom and Canada also apply ICR to privately originated or privately held loans. ICR systems differ along three major dimensions: income threshold for required repayments, method of determining the borrower's interest rate, and method of collecting repayments.

Income threshold:

- ICR plans in most countries specify certain income thresholds below which loan borrowers are not required to make any repayments. Once the borrower has reached or exceeded the set threshold, payments are usually determined according a percentage of annual income (as in the United Kingdom, Sweden, and Australia) or of income above the threshold (as in New Zealand). Canada

does not have an ICR plan *per se* but does have "debt reduction" where the government pays off a portion of the loan principal if a borrower's annual payments exceed a given percentage of their annual income (with adjustments for such factors as family size). Canada's system might be considered closer to "income sensitive" loans than true ICR.

Borrower interest rate determination:

- Some countries (such as Australia) set borrower interest rate at zero real interest. Others (such as New Zealand and Sweden) set a positive nominal rate.
- Some countries cap interest rate against sharp rises in inflation: i.e., United Kingdom.
- A few countries forgive or defer some or all interest during repayment, depending on borrower's income. In Canada, the government will pay a percentage of interest based on the borrower's income level. In New Zealand, a portion of the interest may be written off if income is below the repayment threshold.

Repayment collection:

- In some countries, such as Australia and New Zealand, the tax authority administers repayments as if they were payments of a separate tax. Other countries, such as Canada, utilize tax refund withholding in cases of prolonged default.
- Borrowers may opt or be required to have estimated payments withheld from their wages. (For example, the United Kingdom offers borrowers a choice of repaying at the end of the year through the income tax return or by making monthly installments through one's employer. In Australia and New Zealand, employers withhold estimated repayments from employees' wages and remit them to the tax authority.)